

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

MARCH 18, 2005

The Honorable TED STEVENS,  
*President Pro Tempore of the U.S. Senate, Washington, D.C. 20510*  
The Honorable J. DENNIS HASTERT,  
*Speaker of the House of Representatives, Washington, D.C. 20515*

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the record of our February 3–4, 2005 public hearing on “*China and the WTO: Assessing and Enforcing Compliance.*”

The Commission used China’s accession to the World Trade Organization as the hearing’s frame of reference, considering both the obligations it placed on China and the trade remedies it provides for U.S. parties. Commissioners heard from senior Administration officials, industry groups, labor organizations, economists, and trade law experts. The Commission was also honored to receive the perspectives of ten Members of Congress representing bipartisan concerns in both the House of Representatives and the Senate about this subject.

There was a general consensus in the testimony that China remains in violation of its WTO obligations in a number of important areas. Witnesses highlighted China’s undervalued currency and lack of protection for intellectual property rights and expressed the view that U.S. Government efforts to move China to address these serious problems have not achieved satisfactory results to date and should be reconsidered. The hearing also dealt with the application of U.S. trade remedies. The Commission heard testimony concluding that the Administration has not effectively utilized anti-dumping duties and the China-specific Section 421 and textile safeguards to offset China’s unfair trade practices. What follows are our key findings in these areas along with a number of recommendations designed to improve the use of U.S. trade remedies and encourage China’s compliance with its WTO commitments.

**Key Areas of China’s Non-Compliance**

***Exchange Rate Practices***

The Commission found in its 2004 Report to Congress that “China is systematically intervening in the foreign exchange market to keep its currency undervalued” and that “the undervaluation of the Chinese yuan has contributed to the U.S. trade deficit and has harmed U.S. manufacturing.” To date, despite high-level dialogue between United States and Chinese officials, there has been no concrete movement by the Chinese government to address the undervaluation of its currency. The bilateral trade deficit reached \$162 billion in 2004, an expansion of 31 percent from 2003. The deficit has increased an average of 25 percent per year since 2002, the first year of China’s membership in the WTO. A similar increase in 2006 would put the bilateral trade deficit over \$200 billion.

The Commission received a written statement from Assistant Secretary of the Treasury for International Affairs Randal Quarles detailing the Administration's position on China's currency regime, which indicates that the long-term goal of U.S. policy and negotiations with China should be a market-based exchange rate system for the Chinese currency. We agree with this goal; however, we do not share the Administration's view that progress toward this goal is proceeding at a sufficient pace to rectify current economic problems. Moreover, structural factors in China's financial system preclude the possibility of near-term success in achieving a stronger yuan and a more balanced trading relationship through increased exchange rate flexibility. Instead, the Commission continues to advocate an immediate significant upward revaluation of the Chinese currency against the U.S. dollar as the necessary near-term objective.

**Recommendation 1:** The Commission recommends that Congress pursue a three-track policy to move China toward a significant near-term upward revaluation of the yuan by at least 25 percent.

- Congress should press the Administration to file a WTO dispute regarding China's exchange rate practices. China's exchange rate practices violate a number of its WTO and IMF membership obligations, including the WTO prohibition on export subsidies and the IMF proscription of currency manipulation. Congress should press the Administration to respond to China's violation of its international obligations by working with U.S. trading partners to bring to bear on China the mechanisms of all relevant international institutions.
- Congress should consider imposing an immediate, across-the-board tariff on Chinese imports unless China significantly strengthens the value of its currency against the dollar or against a basket of currencies. The tariff should be set at a level approximating the impact of the undervalued yuan. The United States can justify such an action under WTO Article XXI, which allows members to take necessary actions to protect their national security. China's undervalued currency has contributed to a loss of U.S. manufacturing, which is a national security concern for the United States.<sup>1</sup>
- Congress should reduce the ability of the Treasury Department to use technical definitions to avoid classifying China as a currency manipulator by amending the 1988 Omnibus Trade Act to (i) include a clear definition of currency manipulation, and (ii) eliminate the requirement that a country must be running a material global trade surplus in order for the Secretary of the Treasury to determine that the country is manipulating its currency to gain a trade advantage.

### ***Intellectual Property Rights***

China improved many of its laws regarding intellectual property rights (IPR) following its accession to the WTO. However, there are still significant shortfalls in both the legal regime and the enforce-

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<sup>1</sup> Commissioner Reinsch dissents from this portion of Recommendation 1.

ment structure. One example is high monetary thresholds that must be crossed before an IPR violator is subject to criminal punishment. China's use of such thresholds is inconsistent with the provisions of the WTO's TRIPS Agreement, which calls for criminal treatment of IPR violations on a commercial scale irrespective of value. Moreover, notwithstanding legal improvements, violations of IPR in China continue virtually unchecked. Witnesses at the hearing cited piracy rates above 90 percent across all copyright industries. China's WTO commitments include effective enforcement of IPR. Therefore, statutory changes without enforcement are not sufficient.

Counterfeit products from China threaten markets for U.S. products in China, in the U.S., and in third countries. Counterfeit goods from China entering the U.S. market also pose a risk to U.S. consumers because they are not likely to meet commercial or government safety guidelines. Often, regulatory seals of approval are falsified along with the product itself. There is a self-evident danger in unsuspecting consumers using sub-standard products in any number of categories, from pharmaceutical products to automobile parts.

China pledged to enact a specific plan for protecting IPR during the April 2004 meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT). The Office of the U.S. Trade Representative (USTR) is conducting an out-of-cycle review of IPR protection in China to determine whether commitments made by China at the JCCT meeting have been carried out. Early indications from industry groups suggest that China has not met those commitments.

USTR maintains a watch list of countries with the most egregious failings in IPR protection that is updated annually in a Special 301 Report. Those countries that have the most onerous acts of IPR violations and "are not engaged in good faith negotiations or making significant progress in negotiations to address these problems" are deemed Priority Foreign Countries and face the possibility of U.S. sanctions. Priority Foreign Countries can move to Section 306 monitoring if they enter into good faith negotiations or make significant progress in addressing the problems. China was labeled a Priority Foreign Country in 1996, but is now only subject to Section 306 monitoring. The Commission believes that China's participation in negotiations regarding IPR issues has not been in good faith to date, as evidenced by unabated IPR violations.

**Recommendation 2:** The Commission recommends that Congress urge USTR to immediately file one or more WTO disputes pertaining to China's violation of IPR obligations, particularly China's failure to meet the requisite standards of effective enforcement, including criminal enforcement, explicitly imposed by the Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement. Moreover, USTR should be pressed to move China from the status of Section 306 monitoring to that of a Priority Foreign Country in reflection of its lack of good-faith negotiations or progress in confronting IPR violations.

## **Structural Issues**

### ***Uncollected Anti-Dumping Duties***

The Department of Homeland Security's Bureau of Customs and Border Protection ("Customs") failed to collect \$260 million in anti-dumping and countervailing duties in 2004. Of that amount, \$224 million related to Chinese imports, with \$213 million of that amount pertaining to Chinese agricultural imports.

Importers of some Chinese goods are circumventing dumping duties by exploiting a loophole known as the "new shipper bonding privilege." Importers of a product subject to an anti-dumping duty are usually required to make a sufficient cash deposit to cover the estimated duty. Pursuant to a 1995 law, importers who receive such products from a new shipper are permitted to post a bond with Customs in lieu of the cash deposit. The bond or cash deposit is intended to function as a guarantee that Customs will be able to collect the requisite dumping duties. The exact duty owed is not determined until one to two years after the importation has occurred. The importer is then either refunded or billed for any difference between the estimated duty and the exact duty. In the case of the uncollected duties, when the exact dumping duty has been determined, the party responsible for payment of the bond often is bankrupt or has "disappeared" and no recourse is available.

**Recommendation 3:** The Commission recommends that Congress repeal the "new shipper bonding privilege" that has allowed many importers of Chinese goods to avoid payment of anti-dumping duties. Importers of goods subject to anti-dumping or countervailing duties should be required to deposit in cash the amount of any estimated applicable duty.

### ***Transitional Review Mechanism***

China agreed, as part of its WTO accession commitments, to submit to a specific annual review of its compliance with WTO obligations during its first ten years in the organization via the Transitional Review Mechanism (TRM). WTO member countries sought such an annual review because China did not meet many of the basic requirements of a market economy. As the Commission has reported in the past, China takes the position that the review is discriminatory and has therefore acted to frustrate the intent of the TRM by refusing to answer questions in writing posed by trading partners during this process and preventing production of a meaningful report. Because of China's initial success in obstructing the TRM, USTR has recently dedicated less effort to making the TRM a consequential forum for raising and resolving issues regarding areas of China's noncompliance, preferring to devote more time to bilateral discussions. For instance, the Government Accountability Office (GAO) reports that USTR submitted questions to China's representative an average of nine days in advance of meetings in 2003, compared to an average of 34 days in 2002. China excused itself from answering some questions by noting that it did not have adequate time to prepare a response.

### ***Market Economy Status***

China is currently and properly labeled a nonmarket economy by the United States, a designation made by the Department of Commerce pursuant to factors set out under law. China is actively seeking market economy status from the U.S. and other countries as a matter of prestige, and because having that status will make less effective anti-dumping remedies applied by trading partners against Chinese goods. The factors to be considered in removing nonmarket economy status include the extent to which the country's currency is convertible, the extent to which wage rates are freely determined by negotiations between labor and management, and the extent to which the government owns or controls the means and decisions of production.

At the JCCT, the United States agreed to establish a working group to help China move toward market economy status designation. The Commission is concerned that the decision by Commerce on whether to designate China a market economy will not be made pursuant to an economic analysis using the above criteria, but rather that political considerations will be given greater weight.

**Recommendation 4:** The Commission recommends that Congress require that the Department of Commerce obtain Congressional approval before implementing any determination that a nonmarket economy has achieved market economy status. Congress should ensure that China continues to be treated as a nonmarket economy in the application of anti-dumping and countervailing duties through 2016, as is explicitly permitted by China's WTO accession agreement, unless China clearly meets the statutory requirements for market economy status.

### ***WTO Dispute Resolutions***

The Commission heard testimony that, in resolving disputes between members, WTO panels and the appellate body often liberally interpret the text of WTO agreements to fill gaps in agreements negotiated by member governments. This is beyond the jurisdiction of the WTO, which should confine itself to arbitration based on explicit agreements among members. In this regard, Article 3 of the Dispute Settlement Understanding establishes that: "Recommendations and rulings of the DSB [Dispute Settlement Body] cannot add to or diminish the rights and obligations provided in the covered agreements." The WTO's handbook on dispute settlement further clarifies: "The rulings of the bodies involved are intended to reflect and correctly apply the rights and obligations as they are set out in the WTO Agreement. They must not change the WTO law that is applicable between the parties or, in the words of the DSU [Dispute Settlement Understanding], add or diminish the rights and obligations provided in the WTO agreements."

Any subjects unaddressed by international agreements must be left to definition or clarification by further negotiations among members. The Commission believes that the United States consented to be bound by explicit obligations as a member of the WTO, in return for which it gained explicit privileges, but did not agree to subject itself to new international obligations created by the dispute resolution process.

**Recommendation 5:** The Commission recommends that Congress establish a review body of distinguished, retired U.S. jurists and legal experts to evaluate the dispute resolution mechanism at the WTO. The review body would consider all decisions made by a WTO dispute settlement panel or appellate body that are contrary to the U.S. position taken in the case. In each instance, a finding would be made as to whether the WTO ruling exceeded the WTO's authority by placing new international obligations on the United States that it did not assent to in joining the WTO. This information would be very helpful to Congress and other public officials in ongoing evaluations of the benefits of U.S. membership in the WTO. If three affirmative findings were made in five years, Congress would be prompted to reconsider the relationship between the United States and the WTO.<sup>2</sup>

## **Effectiveness of U.S. Trade Remedies**

### ***Section 421 Safeguard***

China agreed as part of its accession to the WTO to allow trading partners to use a product-specific safeguard in cases of market disruption. The United States implements this safeguard through the petition process codified by Section 421 of the Trade Act of 1974, allowing aggrieved U.S. companies to petition the ITC when they believe imports from China have caused market disruption and material injury. After the ITC makes its determination as to whether market disruption has occurred, an interagency group chaired by USTR considers the ITC recommendation and makes its own recommendation to the President.

The Commission heard testimony that the Chinese government employs U.S. lobbying and legal firms to make its case to the interagency group, or members thereof. Since the government of China has greater financial resources than individual U.S. firms seeking relief under Section 421, the Chinese government may be more effective in such lobbying processes. To date, the International Trade Commission (ITC) has rejected two petitions and found that market disruption had occurred in three other cases. In each of these three cases, the President rejected the ITC's recommended relief, exercising his statutory authority to waive relief when the "provision of such relief is not in the national economic interest of the United States or, in extraordinary cases, that the taking of action ... would cause serious harm to the national security of the United States." Witnesses told the Commission that these actions have made firms reluctant to pursue Section 421 actions and thereby undermined its effectiveness as a trade remedy. If early petitions are consistently rejected, other companies will not spend the resources to seek such relief, and China's government will have effectively voided implementation of the China-specific safeguard which it already agreed to but complains is discriminatory.

The Commission believes that the intent of the 421 safeguard includes a presumption of relief, but that cases to date have displayed a predisposition against any relief. No new petitions have been filed in over a year, and industry representatives note that

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<sup>2</sup> Commissioner Reinsch dissents from this recommendation.

the legal fees involved are unjustifiable given an expectation that the President will deny relief even if the ITC recommends it.

**Recommendation 6:** The Commission recommends that Congress authorize compensation to petitioners in the Section 421 safeguard process for legal fees incurred in cases where the ITC finds that market disruption has occurred but the President has denied relief. Congress should also consider eliminating Presidential discretion in the application of relief through Section 421 petitions or limiting discretion to the consideration of non-economic national security factors.

### ***Anti-dumping Duties and the CDSOA***

The Continued Dumping and Subsidies Offset Act of 2000 (CDSOA, also known as the Byrd Amendment) transfers revenue collected through anti-dumping duties to U.S. producers harmed by the dumped imports. The WTO has ruled that the CDSOA violates U.S. obligations governing permissible responses to dumping and subsidies, and has authorized retaliatory measures by U.S. trading partners if the United States maintains the CDSOA.

**Recommendation 7:** The Commission recommends that Congress maintain the Continued Dumping and Subsidies Offset Act of 2000 (CDSOA), notwithstanding the WTO determination that it is inconsistent with the WTO Agreement. Congress should press the Administration to seek explicit recognition of the existing right of WTO members to distribute monies collected from anti-dumping and countervailing duties during the Doha Round negotiations and the review of the WTO's dispute resolution mechanism.

### ***Textile Safeguard***

China agreed as part of its WTO accession to allow its trading partners to exercise a textile safeguard whereby countries could place a temporary limit on textile imports from China when a surge in imports causes or threatens to cause a market disruption in designated product categories. Under U.S. law, the safeguard is implemented through consideration of petitions by the Committee on the Implementation of Textile Agreements (CITA), an inter-agency committee chaired by the Commerce Department. A number of petitions were filed in anticipation of a sharp increase in imports following the expiration of the Multi-Fiber Arrangement on January 1, 2005. The Court of International Trade (CIT) is currently considering a suit filed by U.S. textile importers alleging that CITA does not have the authority to consider threat-based petitions, but only petitions based on past and ongoing injury. The Commission notes that China's accession agreement clearly allows for threat-based safeguards.

Despite that, the Court has granted an injunction against consideration of threat-based petitions until the case is decided. All petitions for relief deriving their basis in an expectation of market disruption, including those filed prior to the expiration of the Multi-Fiber Arrangement, are currently suspended. The Justice Department has appealed to the Court of Appeals for the Federal Circuit to have the preliminary injunction removed.

**Recommendation 8:** The Commission recommends that Congress clarify without delay the authority of the Committee on the Implementation of Textile Agreements (CITA) to consider threat-based petitions.

***Countervailing Duties and China's Subsidies***

The Commission heard testimony that China's government is subsidizing a broad array of industries via direct and indirect methods. However, U.S. producers cannot seek protection through countervailing duty laws because the Department of Commerce, in a series of decisions finalized in 1986, opted not to allow the application of countervailing duties to nonmarket economies, such as China. Commerce's practice was upheld by the U.S. Court of Appeals, but is not required by law.

**Recommendation 9:** The Commission recommends that Congress direct the Department of Commerce to make countervailing duties applicable to nonmarket economies.

**Recommendation 10:** The Commission recommends that Congress direct USTR and Commerce to investigate China's system of government subsidies for manufacturing, including tax incentives, preferential access to credit and capital from financial institutions owned or influenced by the state, subsidized utilities, and investment conditions requiring technology transfers. The investigation should also examine discriminatory consumption credits that shift demand toward Chinese goods, particularly as a tactic of import substitution for steel, Chinese state-owned banks' practice of non-commercial-based policy lending to state-owned and other enterprises, and China's dual pricing system for coal and other energy resources. USTR and Commerce should provide the results of this investigation in a report to Congress that assesses whether any of these practices may be actionable subsidies under the WTO and lays out specific steps the U.S. Government can take to address these practices.

Thank you for considering these recommendations and the hearing record that they accompany. The Commission will continue to follow these important issues in its ongoing assessment of U.S.-China trade and economic relations.

Sincerely,



C. Richard D'Amato  
*Chairman*



Roger W. Robinson, Jr.  
*Vice Chairman*